No. 733.

IN THE

Supreme Court of the United States

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Blakely D. McCaughn, United States Collector of Internal Revenue, *Petitioner*,

v.

Charles H. Ludington, *Respondent*.

Certiorari to a judgment of the Circuit Court of Appeals for the Third Circuit.

MEMORANDUM IN REPLY TO BRIEF FOR PETITIONER.

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Press of Byron S. Adams, Washington, D. C.

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MEMORANDUM IN REPLY TO BRIEF FOR PETITIONER.

As the brief on behalf of the petitioner was not served on the respondent's counsel until after the latter's brief had been printed and served, the following reply memorandum is filed on behalf of the respondent.

I.

The principal argument in the petitioner's brief is based upon the assumption, stated in various forms and ways, that Congress in the several Revenue Acts contemplated and intended to provide only for "actual loss" and not for "paper" or "fictitious" or "false" or "conjectural" loss; that to allow as a loss an actual and conceded depreciation "in the fair market price or value" as of March 1, 1913, would be an objectionable "gratuity," and that "a tax law is practical and deals with realities and not 'might-have-beens.'" (Petitioner's brief, pp. 5, 6, 7, 9, 13). This is supplemented by the contention that market valuation is a "false factor," that "the practical man gives little heed to temporary fluctuations in market values," and that "quoted market values are often highly conjectural" and often "fictitious."

The careful and distinctly significant language of Congress should also be noted. The basis and test were to be "the *fair* market price or value," for the patent purpose of excluding what the Government now urges (brief, p. 6) as "temporary fluctuations in market values."

It need, of course, only be recalled that "fair market value," instead of being a "false factor," is recognized in all civilized countries as the only generally acceptable factor, and that it is daily received and applied in all our courts as essentially the best and most reliable evidence of actual value. The petitioner, in demurring to the statement of claims (pp. 4-5), admitted on the record and for all purposes that in each case "the fair market value of said shares" was as alleged by the plaintiff.

The reasoning that market value is a "false factor" was supposed to have been long since refuted by the court itself. Thus, in the leading case of *Adams Express Company v. Ohio* 166 U. S. 185, 219, it was insistently urged at the bar by the counsel of the Express Companies that market value with its fluctuations was not a proper basis for determining value of property for taxation, because the so-called actual value of the physical property, for example, of the Adams Express Company was shown to be only $4,000,000, and that, although the market value of its shares was $16,800,000, such market value was ever subject to fluctuation and hence unreliable and a false and misleading factor in determining the true value of the Express Company's tangible and intangible property for purposes of taxation. The language then used by Mr. Justice Brewer, speaking for the court, seems to be quite in point in view of the present argument of the petitioner and particularly at p. 6 of his brief. Thus in 166 U. S. at p. 219 we find the following:

> "The first question to be considered, therefore, is whether there is belonging to these express companies intangible property—property differing from the tangible property—a property created by either the combined use or the manner of use of the separate articles of tangible property, or the grant or acquisition of franchises or privileges, or all together. To say that there can be no such intangible property, that it is something of no value, is to insult the common intelligence of every man.
>
> "Now, it is a cardinal rule which should never be forgotten that whatever property is worth for the purposes of income and sale, it is also worth for purposes of taxation. * * *

"But what a mockery of substantial justice it would be for a corporation, whose property is worth to its stockholders for the purpose of income and sale $16,800,000, to be adjudged liable for taxation upon only one-fourth of that amount. The value which property bears in the market, the amount for which its stock can be bought and sold, is the real value. Business men do not pay cash for property in moonshine or dreamland. They buy and pay for that which is of value in its power to produce income, or for purposes of sale. * * *

"In conclusion, let us say that this is eminently a practical age; that courts must recognize things as they are and as possessing a value which is accorded to them in the markets of the world, and that no finespun theories about situs should interfere to enable these large corporations, whose business is carried on through many States, to escape from bearing in each State such burden of taxation as a fair distribution of the actual value of their property among those States requires."

II.

As argued more or less fully in respondent's brief already filed at pp. 15-20, Congress intended that "the fair market price or value as of" March 1, 1913, should be taken as "the capital value," just as any individual in practical affairs, or any government officials for purpose of taxation or condemnation, would take any such "fair market price or value" as the best evidence and the most reliable factor in determining actual capital value. No ordinary business man in estimating or determining what was the *capital value* of his property would adopt *cost* if the fair market value thereof was substantially more or less than cost, and it would be little short of preposterous to argue at this

late day in a court of justice that for either taxation or condemnation purposes fair market value was not the best evidence of actual capital value.

After the decision of the court in *Doyle v. Mitchell*, 247 U. S. 179, 185 (cited at p. 20 of respondent's brief), the Treasury Department in T. D. 2740, under date of June 24, 1918, issued the following direction (*vide* App. p. 14):

> "(b) In order to determine whether there has been gain or loss on a sale, and the amount of the gain, if any, in general under all three acts" (*i. e.* Revenue Acts of 1909, 1916 and 1918), "an amount must be withdrawn from the gross proceeds sufficient to restore the cost of the property *or the capital value that existed at the commencement of the period under consideration (either January 1, 1909, or March 1, 1913).*" (Italics ours.)

When the Revenue Act of 1918 was amended in 1921 in view of the decision of this court in the *Goodrich* and *Walsh* cases (255 U. S. 527 and 536), the Report of the Committee on Finance of the Senate, presented in September, 1921, contained the following statement (at p. 10):

> "Section 202 provides in detailed form for the basis (used in the case of the sale or other disposition of property) for determining gain or loss. Because of the decisions of the Supreme Court in the case of *Goodrich v. Edwards* and *Walsh v. Brewster* (decided Mar. 28, 1921), it is necessary to state implicitly in the statute the method of treating gain or loss accrued prior to March 1, 1913. *Heretofore property held on March 1, 1913, has been considered capital as of its value on that date.* The concession of the Solicitor General in

the above cases, adopted by the court, is to the effect that gain or loss in every case is determined upon the basis of cost or acquisition value and not by the March 1 value of the property, the gain or loss accruing before March 1, 1913, however, being excluded for purposes of computing the net income subject to tax." (Italics ours.)

It was clearly the result of a misapprehension to state that this court in the *Goodrich* and *Walsh* cases had adopted the concession of the Solicitor General as to *losses!* Nothing in the opinion warranted any such assumption. In the *Goodrich* case it was stated in both brief and oral argument by counsel for the plaintiff-in-error (the writer of the present memorandum) that no question as to deductible losses was presented, that deductible losses involved quite different considerations, and that the attempt to couple them in the Solicitor General's brief was unwarranted. Furthermore, when the then Solicitor General replied he nevertheless sought to argue that his confession of error must be applied likewise to losses, but he was interrupted by the court, and he thereupon admitted that no question as to deductible losses was then presented, and was told that he need not argue any further as to losses if that point were not before the court.

In the Report of the Committee on Ways and Means of the House of Representatives, reporting the 1921 bill, the following statement was made as quoted in the petitioner's brief now before the court at p. 15:

> "Section 203. In the case of property acquired before March 1, 1913, under existing law, the basis for determining gain or loss is the fair market price or value of such property as of that date. The decision of the Supreme Court in the case of *Merchants Loan & Trust Co. v. Smietanka* (de-

cided March 28, 1921), *makes necessary not a fundamental modification of that rule but a more detailed statement of its application.*" (Italics in petitioner's brief.)

Reference to the case cited, however, will show (255 U. S. 509) that it did not present any question as to taxable gains such as was involved in the *Goodrich* and *Walsh* cases, but on the contrary involved simply the appreciation of the value of securities, which it was contended was capital and not income at all. There was no question of losses. Yet, with all the emphasis of italics the statement of the Ways and Means Committee above quoted is now cited at p. 16 of petitioner's brief apparently to sustain the proposition that—

> "The law was not changed, but certain particulars were stated in detail, which before had been left to inference. And, always, in this as in the previous acts, loss and gain are considered correlative and interdependent."

(See also petitioner's brief at p. 12.)

It is submitted by respondent that as a matter of fact loss and gain had not been correlative and interdependent in any of the previous acts, as will be seen by reference to respondent's brief pp. 16, 17, 19.

III.

The constant repetition of the insistence of the Government that Congress was always dealing with *actual* losses determinable by *actual* cost may be inadvertently and unintentionally quite misleading, although, of course, in some cases deductible loss may be equivalent to actual loss.

Thus, the Revenue Act of 1913 allowed no deduction at all for capital losses in transactions, as in the case at bar, not connected with the taxpayer's business (respondent's brief p. 19), and the Act of 1916 allowed the deduction only to the extent of "the losses *actually* sustained therein during the year to an amount not exceeding the profits arising therefrom."

Under none of the Revenue Acts has *actual* loss determined by *actual* cost been generally allowed as a deduction. Under the Acts of 1918 and 1921, if property had been purchased prior to March 1, 1913, no deductible loss was allowed unless the selling price was less than the fair market price or value on that date. For example, under these statutes, if property which cost $100,000 prior to March 1, 1913, was only of the fair market value of $50,000, as of that date, and was subsequently sold for $50,000, not one dollar of loss was deductible although the *actual* loss determined by cost would manifestly be $50,000. Whilst under the Act of 1924 there would be a deductible loss of $50,000 because cost was "greater" than market value as of March 1, 1913.

The argument that Congress in any of the Acts intended gains and losses to be correlative and interdependent or that it intended to establish (as argued in the *Flannery* case, No. 527 at p. 11) "a uniform, harmonious, and consistent basis" will be readily refuted by reference to other provisions of the several statutes and the regulations then in force and which are still enforced unamended.

An examination of the several Revenue Acts will conclusively show that Congress must have constantly had in mind the two bases or standards of cost and market value as of March 1, 1913; that it intentionally

differentiated between them, and that it must have meant what it repeatedly said as to fair market value *instead of cost* in respect of property acquired before that date. For particular examples, we may refer to the statutory provisions as to inventories, destruction of or damage to property, exhaustion, wear and tear, depreciation and depletion: in every such case the fair market value on March 1, 1913, was fixed as the basis in respect of property acquired before that date and not its cost or capital invested therein (App. 5-6, 23, 24, 47, 49). The contrary statement on page 8 of petitioner's brief must be an inadvertent error, for it is clearly in conflict with the Act of 1918 and the Regulations. (App. 23-4, 27, 33-4.) The Department so construed the statute in the most explicit terms (App. 7, 9, 13, 15, 18, 20-1, 25, 27, 29, 33-4). And as stated on p. 45 of the appendix to respondent's brief (not challenged by petitioner), the regulations as to deductions for depreciation and depletion have not been amended since the decision in the *Goodrich* and *Walsh* cases.

IV.

The brief on behalf of petitioner urges (p. 19) that the construction given to existing laws by the executive officials charged with their enforcement is entitled to great weight. That rule, of course, is very well settled. Both sides urge its soundness and applicability. The respondent, however, contends that it should be enforced for his protection as a taxpayer. For more than five years in all regulations and forms prescribed for income tax returns fair market value as of March 1, 1913, was consistently prescribed by the executive offi-

cials charged with the enforcement of the law (Respondent's brief, p. 40). Innumerable taxpayers acted and relied upon this governmental construction, and it is surely as great a hardship as it is an injustice to be mulcted years afterwards and compelled to pay additional income taxes by reason of a belated change of construction by the Department. No more confusion will result from upholding the original and long enforced construction than from setting it aside in favor of the later construction which was based upon a misapprehension of the effect of the decision in the *Goodrich* and *Walsh* cases. The statement that the subsequent rulings have been "accepted" to be found at p. 21 of petitioner's brief is hardly warranted by the facts, for the records of the Department show the contrary and the challenge from the beginning of the correctness of the new construction by numerous taxpayers.

Nor is it fair to compare the plaintiff-respondent to speculators in the market or to suggest that he is seeking a gratuity without equity thereto. The tax for 1919 which he originally paid without protest or claim of reduction was $86,754.46, but he was compelled to pay a total of $91,682.40 including the $3,094 now in controversy based on the high rate of 68 per cent. There is no element of speculation or "playing the market," as the current phrase puts it, for the securities involved had been concededly acquired by the plaintiff prior to March 1, 1913, and had been held by him for at least six years (p. 3).

V.

As to the New York cases relied on by petitioner, it need only be said that they adopted the erroneous view

of the Attorney General of the United States as to the *Goodrich* and *Walsh* cases applying to losses. *People ex rel. Klauber v. Wendell,* 196 App. Div. 827, and *People ex rel. Keim v. Wendell,* 200 App. Div. 388. This is true likewise of the later decision in *Matter of Bush v. Law,* 206 App. Div. 800, which merely followed the two prior cases. But in the meantime, as Mr. Justice Hasbrouck points out (at p. 802) in his able and persuasive dissenting opinion in the last cited case, the New York Tax Law was amended by the Legislature (Laws 1921, ch. 573) so as to add the following:

> "No loss shall be deemed to have been sustained if either *the cost or* the fair market price or value on January 1, 1919, is less than the value realized."

Washington, January 12, 1925.

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